

## Internal Revenue Service

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## Department of the Treasury

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### LEGEND:

Government =

Fund =

Newco =

Policyholders =

Law =

Subs =

Governor =

Board =

Legislature =

Privatization Legislation =

Insurance Business =

Interests =

Agency =

State X =

Year 1 =

Year 2 =

Year 3 =

Date 1 =

Date 2 =

Dear \_\_\_\_\_ :

This letter responds to your December 16, 2011 letter requesting rulings under sections 351 and 832 of the Internal Revenue Code of 1986, as amended (the "Code"), regarding the Proposed Transaction (defined below). The information provided in that letter and in later correspondence is summarized below.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

### **SUMMARY OF FACTS**

Fund conducts the Insurance Business throughout State X to allow Fund Policyholders to comply with the Law. The Government established Fund in Year 1 as part of the Agency. In Year 2, Fund became an unincorporated agency of the Government. Under Fund's enabling statute, the Governor appoints the Board and the Board appoints a manager to oversee the daily operations of Fund. Fund is subject to oversight by the Legislature, and all money in Fund would be subject to disposition by the Legislature if the Law was repealed. Fund directly and indirectly wholly owns the stock of the Subs.

For Federal income tax purposes, Fund is classified as a tax-exempt organization under section 501(c)(27)(B) and uses the accrual method of accounting to compute its income on a calendar year-end basis. For purposes of this letter ruling, Fund is not recognized as an entity separate from the Government.

In Year 3, the Government moved to privatize the Insurance Business conducted by Fund. The Privatization Legislation, which became effective on Date 1, temporarily continued Fund to provide for a transition period to allow the Board to establish a successor mutual insurer corporation to Fund.

### **PROPOSED TRANSACTION**

Pursuant to the Privatization Legislation, and to achieve what are represented to be valid business reasons, the following transactions that constitute the "Proposed Transaction" will occur on Date 2:

- (i) All of the assets of Fund will be transferred to Newco and Newco will assume the liabilities associated with the Insurance Business by operation of law. All policies owned by Policyholders along with any advanced deposits placed with Fund will novate to and be

deposited in an account with Newco, respectively. As a result, all of the rights and obligations of Fund, including those rights and obligations under policies issued by Fund, will become the rights and obligations of Newco. Newco will use the accrual method of accounting and have a calendar year-end.

The “novation” satisfies State requirements, if any, with respect to the policyholder and/or insurance department notification and consent for assumption reinsurance contracts.

- (ii) Newco will issue the Interests directly to the Policyholders. The Interests will entitle the Policyholders to receive dividends, if and when declared, and to share in the assets of Newco in the event of a liquidation. The Policyholders will hold all of the voting power of Newco immediately after the Proposed Transaction. No rights or property will be issued or transferred by Newco directly to Fund.
- (iii) Fund will cease to exist for all purposes and the Government will no longer have any rights or obligations in the Insurance Business or in Newco.

## **REPRESENTATIONS**

Newco makes the following representations regarding the Proposed Transaction:

- (a) Fund is an organization that is an integral part of the Government and therefore not eligible to be classified under Treas. Reg. § 301.7701-2(b) as a corporation for Federal income tax purposes.
- (b) Newco qualifies as an insurance company for Federal income tax purposes.
- (c) No stock, securities, or other ownership interests will be issued for services rendered to or for the benefit of Newco in connection with the Proposed Transaction.
- (d) No stock, securities, or other ownership interests will be issued for indebtedness of Newco that is not evidenced by a security or for interest on indebtedness of Newco which accrued on or after the beginning of the holding period of Fund for the debt.
- (e) All rights, title and interests for each copyright, in each medium of exploitation, will be transferred to Newco.

- (f) Fund will not retain any significant power, right, or continuing interest, within the meaning of section 1253(b), in any trademarks or trade names being transferred.
- (g) None of the stock or other ownership interests to be transferred will be “section 306 stock” within the meaning of section 306(c).
- (h) The Proposed Transaction will not be the result of the solicitation by a promoter, broker, or investment house.
- (i) Fund will not retain any rights in the property transferred to Newco.
- (j) The value of the stock received in exchange for accounts receivable will be equal to the net value of the accounts transferred, *i.e.*, the face amount of the accounts receivable previously included in income less the amount of the reserve for bad debts.
- (k) Any debt relating to the stock of the Subs being transferred that is being assumed (or to which such stock is subject) was incurred to acquire such stock of the Subs and was incurred when such stock was acquired, and Fund is transferring all of the stock for which the acquisition indebtedness being assumed (or to which such stock is subject) was incurred.
- (l) The adjusted basis and the fair market value of the property transferred by Fund to Newco will be, in each instance, equal to or in excess of the sum of the liabilities assumed (as determined under section 357(d)) by Newco.
- (m) The aggregate fair market value of the assets transferred by Fund to Newco will exceed the sum of (i) the amount of liabilities to be assumed (as determined under section 357(d)) by Newco in connection with the exchange, (ii) the amount of liabilities owed to Newco by Fund that will be discharged or extinguished in connection with the exchange, and (iii) the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 351(a) without the recognition of gain) to be received by Fund in connection with the exchange. The fair market value of the assets of Newco will exceed the amount of its liabilities immediately after the exchange.
- (n) The aggregate fair market value of the property transferred to Newco will be equal to or exceed the aggregate adjusted bases of such property immediately after the exchange.
- (o) The liabilities of Fund to be assumed (as determined under section 357(d)) by Newco will be incurred in the ordinary course of business and will be associated with the assets to be transferred.

- (p) There will be no indebtedness between Fund and Newco, and there will be no indebtedness created in favor of Fund as a result of the Proposed Transaction.
- (q) The transfers and exchanges will occur under a plan agreed upon before the Proposed Transaction in which the rights of the parties are defined.
- (r) All exchanges will occur on approximately the same date.
- (s) There is no plan or intention on the part of Newco to redeem or otherwise reacquire any stock, indebtedness, or other ownership interests issued in the Proposed Transaction.
- (t) Taking into account any issuance of additional shares of Newco stock or other ownership interests; any issuance of stock or other ownership interests for services; the exercise of any of Newco stock rights, warrants, or subscriptions; a public offering of Newco stock; and the sale, exchange, transfer by gift, or other disposition of any of the stock or other ownership interests of Newco to be received in the exchange, by virtue of requiring the Fund Board to “perform all acts necessary” to establish a “successor” mutual insurance corporation (Newco) and by directing the transfer of all of Fund’s assets and obligations to Newco, Government will be in “control” of Newco within the meaning of section 368(c).
- (u) The Interests issued by Newco in the Proposed Transaction will be approximately equal to the fair market value of the property transferred to Newco.
- (v) Newco will remain in existence and retain and use the property transferred to it in a trade or business.
- (w) There is no plan or intention by Newco to dispose of the transferred property other than in the normal course of business operations.
- (x) Each of Fund and Newco will pay its own expenses, if any, incurred in connection with the Proposed Transaction.
- (y) The Proposed Transaction will not constitute transfers of property to an investment company within the meaning of section 351(e)(1) and Treas. Reg. § 1.351-1(c)(1)(ii).
- (z) Fund was not, and will not be, under the jurisdiction of a court in a Title 11 or similar case (within the meaning of section 368(a)(3)(A)) and the equity interests received in the exchange will not be used to satisfy the indebtedness of such debtor.

- (aa) Newco will not be a “personal service corporation” within the meaning of section 269A.
- (bb) Fund would be permitted under the Constitution of State X to own all of the stock or other equity ownership interests in Newco.
- (cc) The Proposed Transaction is motivated in substantial part by *bona fide* business purposes unrelated to Federal income taxes.
- (dd) Newco will report its operations on a calendar-year basis using the accrual method of reporting prescribed by the National Association of Insurance Commissioners.
- (ee) The Proposed Transaction will have no effect on those policyholders that are directly insured by Subs.

### **RULINGS**

Based solely on the information and representations submitted, we rule as follows on the Proposed Transaction:

1. For Federal income tax purposes, the Proposed Transaction will be treated as if (a) the Government (through Fund) transfers the Insurance Business and Subs to Newco in exchange for all of the Interests in Newco and the assumption by Newco of related liabilities (collectively, the “Exchange”) and (b) the Government (through Fund) transfers the Interests to the Policyholders (see D’Angelo Associates, Inc. v. Commissioner, 70 T.C. 121 (1978)).
2. The Interests deemed received by the Government (through Fund) in the Exchange will be treated as stock for purposes of section 351(a).
3. Except as provided in ruling 4, the Government (through Fund) will recognize no gain or loss in connection with the Exchange (sections 351(a) and 357(a) and (c)). The requirement of section 351(a) that the Government (through Fund) control Newco immediately after the Exchange will be satisfied because the Government (through Fund) has the right, in choosing the method of privatizing the Insurance Business conducted by the Government (through Fund), either to retain the Interests or to designate other persons to receive the Interests (see D’Angelo Associates, Inc. v. Commissioner).
4. Section 304(a) (and not section 351(a) and not so much of sections 357 and 358 as relates to section 351) will apply to Newco’s acquisition of the portion of the stock of the Subs treated as received in exchange for Newco’s assumption of the Government’s (through Fund) liabilities (section 304(b)(3)(A)). The acquisition by

Newco of the portion of the stock of the Subs treated as received in exchange for Newco's assumption of the Government's (through Fund) liabilities will be treated as a distribution in redemption of a corresponding portion of Newco stock, subject to the limitations and provisions of section 302.

5. No income, gain, or loss will be recognized by Newco as a result of the Exchange (section 1032(a)).
6. To the extent that section 351 applies to the Exchange, the basis of each asset received by Newco in the Exchange will equal the basis of that asset in the hands of the Government (through Fund) immediately before the Exchange (section 362(a)).
7. To the extent that section 351 applies to the Exchange, the holding period of each asset received by Newco in the Exchange will include the holding period of that asset in the hands of the Government (through Fund) immediately before the Exchange (section 1223(2)).
8. For the year in which Fund enters the Proposed Transaction, the income reflected by Newco will be computed pursuant to the principles of section 832, and Newco will include in its unpaid losses, at the beginning of that year for purposes of section 832(b)(5), the ending balances of unpaid losses (determined pursuant to section 846 on a discounted basis) that Fund held immediately before the transaction, in connection with the policies that were the subject of the transaction, and Newco will not take into premium income for purposes of section 832(b)(4) any amount with respect to the assets transferred to it in consideration of the assumption of liabilities in connection with the transaction. (See Rev. Rul. 94-45, 1994-2 C.B. 39.)
9. For the year in which Fund entered into the Proposed Transaction, premiums earned by Newco will be computed pursuant to the principles of section 832(b)(4), and Newco will include in its beginning unearned premiums the ending balances of unearned premiums (computed at 80 percent, pursuant to section 832(b)(4)(B)) that Fund held immediately before the transaction, in connection with the policies that were the subject of the transaction. (See Rev. Rul. 94-45, 1994-2 C.B. 39.)
10. The realization of the value of any insurance in force transferred in the exchange will not be subject to the provisions of section 832, nor will Newco be entitled to deduct as a deferred expense, under sections 832(b)(6) or 832(c), an amount equal to that value.

### **CAVEATS**



Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

### **PROCEDURAL STATEMENTS**

This ruling letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

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Lewis K Brickates  
Chief, Branch 4  
Office of Associate Chief Counsel (Corporate)

cc: